Debunking the Megabank Myths

By U.S. Senator Edward E. Kaufman

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Mr. President, I rise to discuss Wall Street reform, because we must get this bill right if we are to prevent another financial crisis like the last one, which almost destroyed our country. The newspapers are filled with reasons why this is so important: In Europe, because a sovereign debt crisis is threatening to become a full-blown bank crisis, the governments of the EU are using taxpayer funds to bail-out Greece.

The hearings before Chairman Levin's Permanent Subcommittee on Investigations have riveted the nation on fraud at the heart of the financial crisis; the widespread use of fraudulent stated-income loans by Washington Mutual; the abject failures of the bank regulatory agencies; the willful neglect of the credit rating agencies; and, finally, the hopelessly conflicted practices of Goldman Sachs, which put its own trading activities above any sense of duty to its customers.

In particular, over the past few weeks, much has been spoken and written about solving the problem of banks that are "too big to fail." As many of my colleagues know, Senator Brown and I, along with Senators Casey, Merkley, Whitehouse, and Harkin, introduced a bill to place strict limits on the size and leverage used by systemically significant banks and non-banks alike. We are now offering this legislation as an amendment to the financial reform bill, because we believe that Congress must reduce these megabanks to a manageable size and cap the leverage they may use in order to limit the risk they pose to our economy. We should never again have banks that are "too big to fail."

As the recent investigations by Chairman Levin, the Financial Crisis Inquiry Commission and others have shown: Even the best-intentioned regulators are no match for gigantic financial institutions, which are structurally complex, functionally opaque, and global in scope. Just as importantly, these financial institutions purposely operate to evade regulatory oversight by means of regulatory arbitrage, accounting and reporting practices that frustrate transparency, and so-called financial innovation that regulators have no chance of fully grasping in real time.

To surrender our nation's economic security to unelected and mostly unconfirmed regulators is both unwise and undemocratic. It is also a gamble. For those of my colleagues who do trust the current set of regulators and have faith in them, I would ask: Who will be the next president? Which regulators will he or she name to oversee the largest banks? What will be their regulatory philosophy? And how much determination and enthusiasm will they bring to the task of forecasting bank risk and risk to the U.S. economy? Of course, no one can answer those questions.

And while resolution authority is necessary, why would we believe that it will work for a $2 trillion megabank with operations in more than 100 countries? And as we saw just months ago, such banks don't simply fail on their own. The very problems that affect one megabank—such as a fall in the value of widely held assets like mortgage-backed securities—will affect every other big bank at the same time. That is what is happening in Europe today — the EU has decided to bail out Greece, before the panic spreads to Portugal, Ireland and Spain.

That is why to me — the choice is clear. We must do more to act preventively.

Making the largest banks smaller is a necessary, but not sufficient, proposal. It is a complementary idea to the regulatory solutions contained in the current bill.

In the 1930s, this body had the courage and foresight to pass laws that maintained U.S. financial stability for generations! But a decade ago, too many forgot the wisdom of those laws. That is our challenge today. We can either do nothing, which would be dangerous and irresponsible. Or we can direct the regulators to do a better job, which may work for a time. Or we can build a strong, clear safeguard to secure the American economy and to protect the American people from ever having to bailout megabanks again.

Brown-Kaufman Amendment

The current bill has many provisions that I support, but, as Moody's reports, "the proposed regulatory framework doesn't appear to be significantly different from what exists today." We must go farther.

The Brown/Kaufman Amendment is not as dramatic as it seems nor is it, I believe, fraught with unintended consequences. Very large banks will still exist under this bill. But they won't be so big that they are "too big to manage and too big to regulate," as former FDIC Chairman Bill Isaac has said. And the leverage they use — the ratio of capital to assets — which is the very basis for how risky they become, will be statutorily capped.

In fact, the extra layer of protection provided by this legislation is the least we should do. Under Brown-Kaufman, big financial conglomerates like Bank of America and Citigroup will still have balance sheets that exceed $1 trillion – about half of their current size. In other words, Citigroup would be about the size that it was in 2002—when it was still very competitive in the U.S. and overseas. The balance sheet of an investment bank like Goldman Sachs would be scaled down from $850 billion to a more reasonable level of just above $300 billion, or around $450 billion if Goldman exits the bank holding company structure. Lest anyone think that this is punitive: Goldman Sachs's assets didn't exceed $100 billion until 2003. The firm is currently well over 10 times the size it was when it went public just over ten years ago.

A recent report by Andrew Haldane, the Executive Director of Financial Stability at the Bank of England, has two charts depicting the incredible growth and concentration that occurred within our financial system over the last ten to fifteen years.

The first chart shows how the average size of a commercial bank relative to GDP has tripled over the 15 years. Of course, this increase was driven by the growth of the megabanks, not by the growth of community or regional banks.

The second chart shows how concentrated the U.S. banking system has become in just the last 10 years. The top three banks represented approximately 20% of overall bank assets in 1999, the time of the repeal of the Glass-Steagall Act. In fewer than 10 years, this percentage has doubled, with these top 3 banks now representing more than 40% of total bank assets.

And the government's response to the financial meltdown has only made the financial industry bigger, more concentrated, and more complex and interdependent: JP Morgan swallowed Bear Stearns and Washington Mutual; Bank of America absorbed Merrill Lynch; and Wells Fargo bought Wachovia.

"Too Big to Manage and Too Big to Regulate"

Why would we want financial institutions this gigantic? The last two years proved beyond dispute that management and risk committees at America's most prestigious firms were unable to effectively track, measure, and mitigate their exposures.

As Andrew Haldane recently noted: "risk and counterparty relationships outstripped banks' ability to manage them. . . . Large banks grew to comprise several thousand distinct legal entities. When Lehman Brothers failed, it had one million open derivatives contracts."

Former Treasury Secretary Robert Rubin recently admitted: "There isn't a way for an institution with hundreds of thousands of transactions a day involving something over a trillion dollars that you are going to know what's in those position books." If leaders of these massive financial institutions have no idea regarding their systemic risk, what hope do regulators have?

The truth is that these financial institutions have become so large and complex that regulators rely upon the banks and the markets to self-regulate. Under the Basel II Capital Accord, determinations on capital adequacy became dependent on the judgments of rating agencies and, increasingly, the banks' own internal models. Modeling is fine, so long as the banks stay between bright lines drawn by Congress. Otherwise, if regulators issue rules governing capital requirements that depend on the banks to use their own models to determine adequacy of their capital and liquidity, then as a practical matter such regulation becomes meaningless.

Indeed, regulators have long had all the tools they need to increase capital and restrict banks from engaging in activities that pose a serious risk to the safety, soundness or stability of a bank holding company. But they failed to do it.

The regulators failed for many reasons, but they failed in part because so much of the risk is hidden and difficult to understand. Institutions like Lehman and Citigroup brazenly engaged in accounting gimmicks to evade regulations that were imposed on them. Lehman implemented "Repo 105" to hide the true extent of its liabilities at the end of each reporting quarter. In the second quarter of 2008 alone, it moved $50 billion temporarily off of its balance sheets without telling regulators, ratings agencies, or even its own board. SEC and Federal Reserve regulators stationed at Lehman Brothers never caught on. And the Lehman CEO claimed he never knew about it. At the same time, Citigroup and others held more than a trillion dollars in off-balance-sheet vehicles to avoid capital requirements for lending. When market conditions soured, tens of billions of dollars in liabilities suddenly appeared back on their balance sheets—to the surprise of regulators and shareholders alike.

Regulatory Arbitrage and Accountability

Some argue that it is the quality of those regulatory standards that must be improved, and that they must be finely tuned and calibrated if they are to affect the behavior of the large banks.

Assistant Treasury Secretary Michael Barr recently noted, markets will "undoubtedly evolve" beyond what any law says. But, he said, regulators are now pushing for new global capital standards that will be "more robust, higher and better quality, less pro-cyclical, and include global agreement on a leverage ratio."

That will be helpful, but it is not a solution. The history of financial regulation has proven that strong and sweeping statutory standards are far tougher to evade than technical regulations that prescriptively set requirements. The *Financial Times* reported recently that banks are already developing new ways to arbitrage the global capital standards to which Secretary Barr refers. In other words, they are finding ways around the rules before they are even finalized.

That is why we need statutory standards on the leverage and size of these megabanks, as provided in the Brown-Kaufman SAFE Banking Act. While some technocrats may say that they are blunt tools, I say that that is precisely the point: the amendment provides a clear line that banks can't evade and regulators can't ignore—thereby making both accountable.

Unfair Subsidy

The federal government cannot continue to subsidize these mega-banks and permit them to grow by taking on ever greater risk and speculation. Dean Baker and Travis McArthur of the Center for Economic and Policy Research compared the borrowing costs of the eighteen largest banks (all of which have over $100 billion in assets) to smaller ones. They estimated that the effective government subsidy – because of the implicit guarantee that they are "too big to fail" – results in a 70-80 basis point borrowing advantage over smaller banks, resulting in lower borrowing costs equal to approximately $34 billion. Fed Chairman Bernanke has noted that this is unfair competition to smaller banks. As a result, less money flows to local communities and small businesses have trouble getting affordable loans.

The Myth of the Need for Big Banks

Nonetheless, there are still those who argue that we need megabanks — that there are economies of scale that allow $2 trillion banks to better service large U.S. global corporations and help us compete globally. They offer no evidence to support this claim, however, because there is none.

There are no academic studies proving that in banking, bigger is better and more efficient beyond $100 billion in assets. While big corporations on some occasions need to access particularly large amounts of capital, Wall Street banks typically form syndicates to spread the risk. And while megabanks have large balance sheets that might allow them to take on a large amount of underwriting risk, it is not clear whether this is good for the customer or the financial system as a whole. By having lots of smaller institutions participate in an underwriting, the corporate customer is apt to get better pricing because it will be accessing a wider variety of retail and institutional distribution channels. The financial system is also safer by not having large concentrations of proprietary positions in loans and securities—or even worse, by having these institutions "hedge" those large exposures with esoteric products that no one understands and that are often hidden off balance sheet.

The International Competitiveness Myth

Nor is there research that demonstrates that the U.S. needs large banks in order to "compete" with massive foreign banks.

It's true that only six of the fifty largest banks in the world are based in the U.S. Many banks on that list have a history of government involvement – some were even owned by their governments. Virtually all of these banks benefit from implicit or explicit government guarantees. Many, including the largest bank on the list, the Royal Bank of Scotland, have been recipients of massive bailouts.

Ireland is in the midst of a painful process of bailing out its largest banks. Switzerland put together an approximately $60 billion bailout package for one of its largest banks, UBS. The U.K.'s bailout support for its banks exceeds $1 trillion. The case of Iceland provides a cautionary tale for all nations on how a government can be completely overwhelmed by the collapse of its largest financial institutions.

And while French and German banks have enjoyed only modest, *direct* bailouts, through the EU and IMF debt relief provided to Greece, these banks have received a massive, *indirect* government bailout. The *Wall Street Journal* reports that German and French banks carry a combined $119 billion in exposure to Greek borrowers and more than $900 billion to Greece and other vulnerable Euro countries, including Ireland, Portugal and Spain. French banks have almost $80 billion in exposures to Greece, while German banks have $45 billion in exposures to the country.

Given these circumstances, other countries face just as urgent a need to break apart their megabanks.

What about Canada, many ask? Its large banks did well during the last crisis. But there are significant differences in our two countries. First, there was no wave of financial deregulation in Canada. Canadian banks are subjected to tight mortgage origination standards and tough leverage limits—something U.S. financial institutions and their regulators completely ignored for the last decade. Second, in Canada the government insures the most risky mortgages — and I don't think we want to go back to doing that. Finally, not one of Canada's largest banks is near the size of any of the five largest U.S. banks. In fact, the largest Canadian bank is not even a third of the size of the largest U.S. bank. What's more, under the limits of the Brown-Kaufman Act, our megabanks would continue to be much larger than the largest Canadian banks.

Most Observers Support Smaller Banks

Some officials have argued that "most observers" think that breaking up the big banks would lead to more risk, not less; that bigger banks are more diversified and therefore less risky than smaller banks. That makes no sense to me. As the Governor of the Bank of England, Mervyn King, recently observed, "Banks who think they can do everything for everyone all over the world are a recipe for concentrating risk." That is one of the reasons why he, too, favors breaking up the megabanks as the solution to "too big to fail."

I believe the view of most observers is best summarized in the review of the literature in *13 Bankers*, the book by Simon Johnson and James Kwak. Breaking up the banks is not a populist idea in the pejorative sense of that word. It is supported by smart informed people outside the Washington-Wall Street corridor who understand what is happening, including three presidents of the Federal Reserve Board and a host of economists and academics.

Even Alan Greenspan, in his recent speech at the Brookings Institute looking back on "The Crisis," stated clearly: "For years the Federal Reserve had been concerned about the ever larger size of our financial institutions. Federal Reserve research had been unable to find economies of scale in banking beyond a modest-sized institution. A decade ago, citing such evidence, I noted that 'megabanks being formed by growth and consolidation are increasingly complex entities that create the potential for unusually large systemic risks in the national and international economy should they fail.' Regrettably, we did little to address the problem."

Conclusion

Anyone can come up with reasons for maintaining the status quo—for allowing over-sized megabanks to continue to be "too big to fail." But given the recent economic disaster, the burden of proof should fall on those who want to retain our currently dangerous concentration of financial power. Repeating the mantra of U.S. competitiveness and the idea that "this is not about size but about risk and interconnectedness" are only excuses for an unjustified failure to act.

The question is what must we do to ensure that a financial crisis like the Great Recession—which continues to cause millions of people to be out of work and lose their homes—never happens again? The Brown-Kaufman amendment would add another layer of protection to our financial sector, and would make it much less likely that US taxpayers will ever be asked to bailout Wall Street again.

Brown-Kaufman is a modest, even conservative, proposal to restore the size of banks to where they were a decade ago. It will also impose a statutory leverage limit to prevent megabanks from taking on too much risk – a fact about our amendment that is often overlooked.

Sometimes, the buck must stop with Congress. We can take strong steps to undo the harm of the last decade, or we can punt responsibility to the very regulators who failed us in the first place. Either way, the American people will hold us responsible. So let us act responsibly and protect them from further harm.